TSX Earnings Watch

October 27, 2011

CIBC

Economics

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Warren Lovely
(416) 594-8041
warren.lovely@cibc.ca

Emanuella Enenajor
(416) 956-6527
emanuella.enenajor@cibc.ca

Andrew Grantham
(416) 956-3219
andrew.grantham@cibc.ca

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TSX Q3 Earnings: *"Great Expectations" But "Harder Times" Could Lie Ahead*

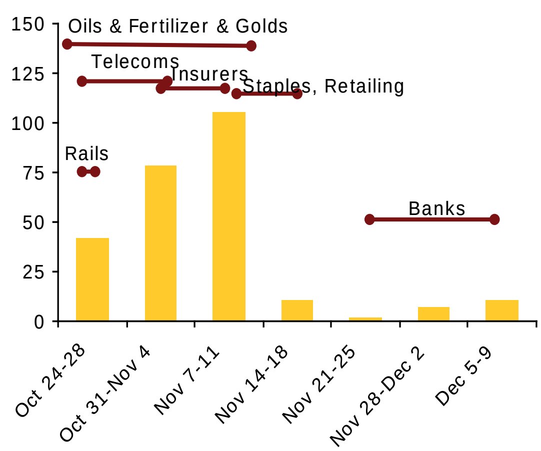
by Peter Buchanan

If there's been a strong card to the North American recovery, offsetting still fragile US labour markets, it's been corporate earnings. With a near-70% beat rate so far, US firms seem once again to be topping the expectation's bar in the recent, uncustomarily high numbers.

The spotlight swings to Canada this week and next. Numbers from the 110-plus Composite members due to report over that period (Chart 1) will provide a good preliminary take on the quarterly profit landscape. Entering the peak reporting period, the analysts' bottom-up consensus from Thomson Reuters is pointing to a rise of 30% in earnings on a year earlier. That's below the 38% increase anticipated a month ago (due in large part to the negative guidance from some key insurers) but still a comparatively good number in the longer run scheme of things. Consistent TSX operating earnings data extend back to the mid-1980s and the average year-on-year growth rate in that period has been about 6%, a touch firmer than nominal Canadian GDP growth.

Chart 1

TSX Composite Members Reporting/Week



Resources, Health & Banks Expected to Drive Q3 TSX Results

Focusing on the contours for the quarter ended, materials and energy firms should once again power aggregate dollar earnings growth, benefiting from historically high commodity prices, especially early in the quarter. A respective near-doubling and 60% increase (Table 1) should see those two key resource areas account for a hefty 45% of all TSX earnings in Q3. That's the largest proportion since the high watermark of the last resource boom in mid-2008, when oil briefly topped $140/bbl, as copper and other metals set recurrent records.

In terms of the sector-by-sector arithmetic, the favourable impact of wider refinery margins on the profitability of the key integrated oil firms is expected to counter the drag from low natural gas prices on the upstream side, resulting in another solid quarterly performance. The gold segment's $1.7 billion positive swing should account

Table 1

Historical & Expected Earnings Growth

Operating Earnings, TSX Composite vs S&P 500

y/y % chg	TSX Composite 2011:Q2	TSX Composite 2011:Q3	*S&P 500 2011:Q3*
Energy	76.4	**57.4**	*49.2*
Materials	72.3	**92.0**	*26.8*
Industrials	30.0	**-1.7**	*16.2*
Consumer Discretionary	-4.1	**10.0**	*19*
Consumer Staples	13.7	**5.0**	*9.1*
Health Care	98.2	**95.2**	*4.8*
Financials	103.3	**15.0**	*10.9*
-Banks	20.0	16.6	*NA*
-Insurers	NM	-54.5	*NA*
Info Tech	-34.8	**-20.9**	*10.1*
Telecom Svcs	9.5	**6.3**	*5.8*
Utilities	11.4	**11.5**	*-3.6*
All Sectors	58.8	**30.1**	*14.7*
-ex resources	*49.2*	*8.6*	*NA*

Note: Aug, Sep or Oct quarter end, as of 27-Oct

NM= not meaningful due to year ago loss; NA=unavailable

Source: Thomson Reuters, CIBC calculations

for over half of the material sector's even more striking earnings momentum, with higher prices and volumes reinforcing the performance of another important sub-sector, agricultural chemicals. Demographics and the demand for cost-saving technologies should give health care a notable lift as in Q2. Better results from media firms are expected to see performance in the consumer discretionary sector improve, with bank earnings growth approximating the previous quarter's respectable pace. As in Q2, intensified competitive pressures represent a negative for IT. Rounding out a generally positive overall picture, earnings in the industrial sector are expected to show little change, as the rails' results help to offset the fallout from high fuel prices on the airlines.

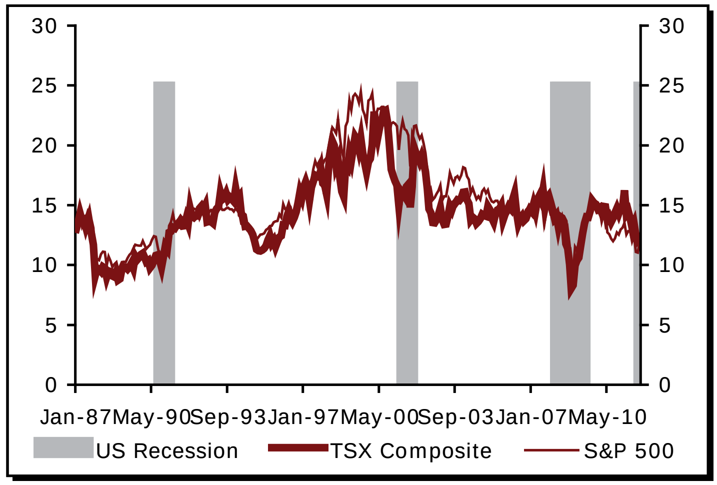
Momentum Should Readily Surpass S&P 500 Large Caps

Comparing the Canadian numbers with those stateside, TSX earnings growth in the quarter should surpass the S&P 500 in six of ten major market sectors. Expectations there are for a rise of 15% in earnings in Q3, about half of the latest bottom-up estimate for the TSX. Contributing to that gap, earnings in the TSX's materials and health sectors are likely to do particularly well relative to the comparable S&P 500 segments.

Based on the latest expectations, the Composite is trading at a PE of 12 against four-quarter future earnings, in line with valuations for the US large caps (Chart 2). That's below the 14½ average of the last quarter century, though it goes without saying that ratio is only as useful as the accuracy of the earnings expectations it's based upon. That, in turn, depends critically on the outlook for resource prices and global growth, since the TSX is in many respects more of a play on the international economy than the domestic one. Earnings downgrades have been running ahead of upgrades by a larger-than-usual margin recently (Chart 3). Pointing to a continuation of that pattern, we still see a few more downside than upside risks to the global outlook, even with this week's eurozone deal. That could hamper the market's ability to build upon what has been a decent performance in October, despite the month's nasty reputation.

Chart 2

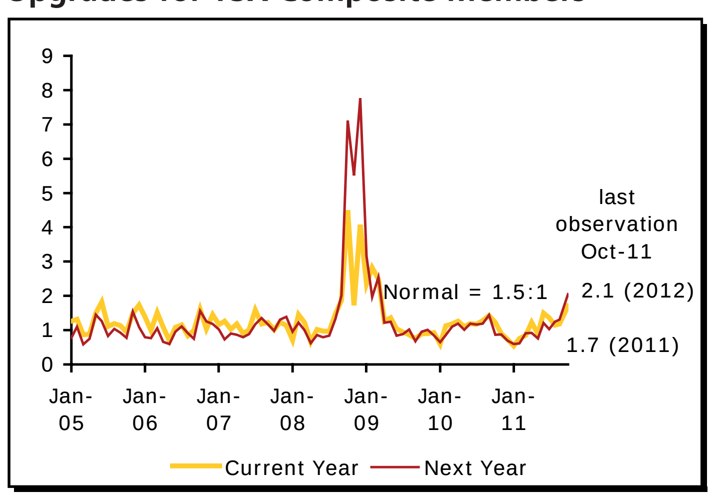
Forward PE Ratios — 12 Months



Source: Thomson Reuters, CIBC calculations

Chart 3

Ratio of Analysts Earnings Downgrades to Upgrades for TSX Composite Members



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